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As I see it

IS A NEW REAL ESTATE BOOM IN THE MAKING ?

MOST real estate booms have developed because of two primary causes: 1. a shortage of acceptable space; and 2. a sharp increase in replacement cost.

The shortage of acceptable space has generally been due to a rapid increase in business activity following a period in which construction was at a low rate.

The rapid increase in replacement cost has generally been due to increased building, or to inflation, or to both.

Let us examine critically the real estate booms in the United States during the past 75 years. The boom which occurred in the late 1880's and the early 1890's followed the big depression of the 1870's, which from the standpoint of real estate was more drastic than the depression of the 1930's. In that depression foreclosures rose to 118 per 100,000 families, as against 84 at the peak of the depression of the 1930's. Of course, it can be argued, and probably correctly, that foreclosures would have gone considerably higher in the 1930's had it not been for the HOLC. During this big depression of the 1870's, new building came to a virtual standstill, and for a period of at least 10 years, building was very much below normal. During this entire period, population was increasing rapidly, and by 1886 real estate activity exploded as an acute housing shortage developed. Building material prices during this period increased only slightly, as the general trend of commodity prices from 1882 to 1896 was downward. In other words, the real estate boom of the late 1880's and the early 1890's was a genuine real estate boom caused by an increase in demand for an article which was in limited supply.

The boom of the early 1900's was due to causes somewhat similar to the boom of the late 1880's and early 1890's. It followed the big depression of the 1890's, a depression, however, not nearly so drastic as the one in the 1870's insofar as real estate was concerned. Foreclosures during this depression rose to only 35 per 100,000 families, approximately one-third of their height in the depression of the 1870's. The boom of the early 1900's was due to an accelerated demand for space plus a rather considerable increase in replacement cost. Building material prices from the middle of 1897 to 1907 increased by 40 percent and this, of course, had a tendency to bring existing useful prop-

erties to a much higher level. The real estate boom of the 1920's was more nearly similar to the boom of the 1940's in that it was due partially to the low level of construction activity during the World War I period and the acute housing shortage which developed at the end of the war, but was due also to a tremendous increase in building material prices, which more than doubled from 1918 to 1920, and which held a fair share of this increase during the remainder of the 1920's. The rapid increase in replacement cost brought a rapid increase in values. This rise in replacement cost was due primarily to the war inflation which reduced the value of the dollar by a considerable amount.

The boom which started in the 1940's followed World War II. It, too, started with an acute housing shortage due to a very prolonged, almost complete cessation of residential construction. Before the shortage could be filled, however, replacement costs rose quite rapidly, doubling in a period of 8 years. This caused rents and values to continue up as new additions to the supply could only be made at a very much higher price. Like the boom of the 1920's, this boom started as a real boom due to an excess of demand over supply. It continued and increased after the initial period, primarily due to the inflationary factors following the unbalanced budgets of the war and postwar periods. During the past 15 years the dollar price of real estate has increased by about 80 percent, but, expressed in dollars of constant purchasing power, there has been practically no change in the values of existing buildings during that period.

What is the outlook for real estate values at the present time? Let us examine the various factors which have caused booms in the past.

1. Before each of our past booms the foreclosure rate was high. Before the boom of the 1890's and before the boom of the 1940's foreclosures were tremendous and devastating. It is true that foreclosures now are double the level of a few years ago, but they are still relatively low, and very little distress property has been thrown on the market thus far. It seems to me, however, that had we had the same type of mortgage financing which we had in the 1920's and in the earlier periods, we would have experienced a rather drastic foreclosure picture during the past several years. Interest rates had risen rapidly, and for a while money was quite tight. Undoubtedly, had property been financed with loans maturing in 3 or 5 years, a larger number of loans would have matured during this tight money period, and many of them could not have been refinanced at that time. The monthly payoff loan, which now accounts for the great majority of all mortgage financing, has, I believe, leveled out the fluctuations in foreclosures, and I doubt whether the high foreclosure peaks of the 1870's and the 1930's will ever be repeated. From that standpoint, therefore, high foreclosures with a fairly rapid drop after the peak, no longer have the forecasting ability for impending real estate booms that they had in the past.

2. Almost all real estate booms in the past have been ushered in by a shortage of acceptable space. Vacancies have shrunk and rents have risen as a result of the shortage. This was certainly true in the boom of the 1880's, the boom of the early 1900's, and especially true in the boom of the 1920's and

the boom of the 1940's. In each of these cases vacancies shrank, putting the tenant at a disadvantage in negotiating for space.

The index of residential rents in the United States, prepared by the Bureau of Labor Statistics as a part of its consumer price index, is still rising slowly. Vacancies, however, during the recession have increased and according to the figures of the Bureau of the Census are relatively high at the present time. As long as vacancies allow tenants considerable leeway in their choice of space, landlords must bid against each other for available tenants, and rents will not rise rapidly. A substantial business boom would probably expand demand in urban areas by a considerable amount. This would cause vacancies to shrink and rents to rise more rapidly than they have during the past few years. This would present a situation more similar to the situations which have developed in the early part of preceding real estate booms.

3. In most of the preceding booms, but not in all, replacement cost new increased rapidly during the period in which the boom was getting underway, making it necessary for the values of existing properties to rise before any volume of new building could be done in competition. In most cases these rapid rises in replacement cost were due to inflation, or, in other words, to the cheapening of the dollar due to unbalanced budgets.

The behavior of the stock market during the past few years would indicate that the investing public is so convinced that inflation will be the order of the day that it is willing to accept minimal returns in exchange for hoped-for long-term capital gains.

The dollar is still going down in value, and the Cold War, plus the tendency of the public to expect more and more service from the Federal Government, will continue the shrinkage. This would not be true if the public were willing to increase tax rates so that these services desired could be paid for out of current revenue, but this the public is not willing to do. I see little chance of balanced budgets in the foreseeable future, and it seems to me that the dollar will lose its purchasing power at an average rate during the next 10 to 20 years of at least 2 percent per year. Will this factor alone bring about a new real estate boom, as investors try to conserve purchasing power by investing in tangibles like real estate?

Real estate has one great advantage in inflationary periods. A well-built building has a very long life. Studies we have made would indicate that a life expectancy for a new building is in excess of 80 years, and even then most buildings torn down prior to urban renewal have come down either because of a higher use for the ground, or because of street widenings, or for other public use. Relatively few have been torn down because they would no longer yield a return greater than that expected on the value of the ground. Many of those that have come down have been wrecked because the value of the land had increased to the point where any remaining value in the improvements was easily absorbed in the value of the ground. If a building can be expected to have an economic life of more than 80 years, an annual depreciation in the value of the

dollar of 2 percent will more than offset the physical deterioration and economic obsolescence of the building.

One other factor which should be remembered is that the urban renewal programs now being followed in a very large number of cities have removed a large number of dwelling units, of very poor quality to be sure, but the former occupants of these units have now been forced to migrate to other units not quite so dilapidated, and in this fashion a considerable surplus has been removed from the market. The result of this demolition and of the slight retardation in new construction is not apparent during a period of recession, as it has probably been more than offset by doubling up during the period of economic strain. It will become quite noticeable as industrial activity increases, and I think that vacancy figures will show some drop in the period ahead.

While I do not anticipate any rapid increases in real estate values during the next few years, I believe we are approaching the period when the accumulation of real estate equities would again be desirable for long-term appreciation. It will be necessary to select these equities far more carefully than at the beginning of the boom of the 1920's or of the 1940's. It made little difference then what type of property was purchased, as all types had a sizable increase. Because of impending tax legislation, particularly that dealing with capital gains on real estate, great care must be exercised in selection. In fact, on many types of income properties if the contemplated tax treatment becomes law, there is a great probability that many of these properties will lose a portion of their value, as many of them were purchased primarily for the tax advantages of the depreciation allowance.

While I do not consider single-family residences for rent as particularly good investments, I do believe that single-family residences in the middle price bracket, occupied by the owner, present a method of stabilizing housing cost close to its present level in a period in which rents will increase. In addition to providing an investment in living, I think that over a period of years single-family residences, occupied by the owner, will give some protection against a depreciation of capital.

In summary, it seems to me that the present economic recovery has not yet advanced sufficiently to absorb the excess vacancy, and until it does, no sharp increases can be expected in rents or in sales prices. The probability of considerable inflation in the period ahead, however, over a period of years will bring about much higher real estate values.

The purchase of investment properties should be deferred until the present tax situation is clarified.

Roy Wenzlick

ROY WENZLICK

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